Audit's NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

Monday, January 17, 1972 VOL.III, No. 1

TRUST SHARES FOR YOUR ATTENTION

INDUSTRY TRENDS

HOW THEY'VE GROWN: NAREIF'S NEW HANDBOOK WEIGHS IN

The 1971-72 Handbook of Member Trusts just published by the National Association of Real Estate Investment Funds testifies by its very bulk to the phenomenal growth of realty trusts. The book weighs in, literally, at 3½ pounds, vs. a slim 1 lb., 3 oz. for the 1969 version. Moreover, the 1969 version was printed on only one side of a sheet of paper, so the present edition can truly be said to be nearly six times as large as the older model. The in-between version in 1970 was a stripling of 2 lb., 6 oz., so that the latest edition is 47% larger than a year ago. The NAREIF handbook includes historical information, balance sheets and income statements for 80 trusts (30 equity trusts, 50 mortgage trusts). It is available for $25 per copy from NAREIF, 1101 17th St., N.W., Washington, D.C. 20026.

MARKET ACTION IMPROVES

Now that the bad news in the trade is long since out, nearly two months ago lending standards of short term trusts were questioned, market action has improved in many cases. What is most impressive to us is what appears to be the healthy and selective nature of price action in recent weeks. The great majority of upward price ticks appear warranted to us in reflecting underlying fundamental values and prospects. Nearby action may be undramatic but moderately rewarding.

KENNETH D. CAMPBELL, EDITOR AND PUBLISHER / **AUDIT** INVESTMENT RESEARCH INC., 230 PARK AVENUE, SUITE 555, NEW YORK, N.Y. 10017 (212) 725-1410

PUBLISHED TWICE MONTHLY ON THE SECOND AND FOURTH FRIDAYS SUBSCRIPTION $84 ANNUALLY GROUP RATES ON REQUEST

NEW TRUSTS DEMONSTRATING INVESTMENT DIVERSITY: TWO ISSUES EXAMINED

Investors are well aware that the construction and development lending markets are becoming more competitive and yields eroding as a consequence. The fear of what this competition can do to yields is one reason trust shares have been less than ebullient of late. Little noticed is the fact that trusts are rapidly diversifying their investment objectives. Some diversification is being done within existing trusts but the major diversification thrust is coming from newly formed trusts. These newer trusts are concentrating in equity investments, intermediate term financing (often with balloons) and in land purchases and other senior equity positions. All have one thing in common: they are doing many things very differently than the typical construction-lending trust.

From the many issues fitting this description, we review below two recent offerings. They have been well received even in the face of the post-Nov. 18 weak market. One of the two came to market without warrants, which is a measure of strength in itself. The pair:

	---Offering---		Price	%
Issue	Date	Price	1/11/72	Change
Continental Illinois Properties	Nov. 9	25	$28.25	+13.0
Larwin Realty & Mtg. Tr.	Dec. 17	20a	21.75a	+ 8.8

a-Units of one share and one warrant

Of all the new offerings lately, certainly the biggest and potentially one of the most dramatic was made in November when *Continental Illinois Properties* raised $100 million on four million shares at $25 each. This is an equity trust whose primary emphasis is ownership and whose results will be measured by cash flow. The prospectus also lists permission to make long-term first mortgage loans coupled with equity interests together with net lease financing and land purchase-leasebacks but all these investment forms will be minor.

Initially, it will be in the category of an investment trust of necessity having to purchase properties and projects in the embryonic development stage. Of the trust's 15 initial equity investments, 14 are 100% ownership and one is for 25%. Twelve were begun mostly in the last few months and construction on the other three is scheduled to start within the next few months. Completion of three is expected in the first half of 1972, seven in late 1972 and five in mid-1973. These initial equity commitments total $47.7 million and lending totals $43.7 million. Most of the latter category is temporary purchase of GNMA securities, government guaranteed packages of pooled mortgages which qualify for realty trust tax regulations. The trust hopes to have its $94 million net proceeds fully invested in permanent equity in about 12 months, 18 months on the outside. In the meantime, meaningful return on investment in the form of cash flow will not become noticable until the third or fourth quarter of 1972. Management is not currently making any projections on rate of return.

Eventually, the trust will switch over to a development vehicle from the investment category. It believes it can do this effectively on the basis of real estate talent and borrowing capability stemming from affiliation with Conill, the one bank holding company whose principal subsidiary, Continental Illinois National Bank, is the ninth largest commercial bank in the country. To begin with, the trust's adviser (manager) is headed by James Harper, Jr. whose credentials include running Continental Illinois Realty, also managed by a Conill subsidiary and one of the most successful short-term construction and development lending trusts. Mr. Harper is the only common trustee of these two trusts. Properties has assembled a staff and trustees which it feels possess the knowledge and experience necessary to develop and assemble the large

body of real estate for a trust of this planned size. In order to multiply its opportunities, the trust intends to use its affiliation with Continental Illinois Realty and joint venture with third parties. The prospectus states the trust will make equity commitments where CIR concurrently makes the short-term loan. Such transactions require the approval of a majority of unaffiliated trustees of both trusts. The equity trust does not plan to make commitments where CIR already has a loan outstanding although it may do so again with majority approval by both sets of unaffiliated trustees. The joint venture route should open up many possibilities.

In financial leveraging, this trust may be able to do better than average. Its big bank association is an important borrowing wedge, something Mr. Harper was after when he first allied his short term trust. Borrowing on a secured basis as equity trusts do, it is felt the trust can realistically go to a 4-to-1 ratio compared to the usual 2 or 3-to-1 limit on short term trusts. Readers should bear in mind, however, that a higher ratio does not automatically mean a higher return on capital as long term borrowings are at higher rates than short term. Beyond normal mortgage financing, there is a swing line of credit for $25 million, later to be extended to $50 million, which will provide for interim financing.

Apartments make up almost the entire property mix of the trust's initial investments. This was done because of the ease of acquiring promising properties in this category and their relative market attractiveness at this time. Eventually, the trust will go a balanced mix of about one-third apartments and two-thirds commercial types such as office buildings and retailing facilities.

It must be recognized that Properties involves greater than usual possibilities for conflict of interest. Beyond the ordinary possible conflict with the adviser, there exists here relationship with a sister trust and the trustees are men of property- they were basically chosen for this reason. We can only summerize here as we have before, the situation is laid out in the open and the chances for dealing at the shareholders' expense look small. What is slightly disturbing is the fact that the trust will apply its 1% annual advisory fee to GNMA certificates. Fortunately this will only be for a short period of time.

There is little fundamental statistical basis for appraising the shares. They sell for about 20% over book value of $23.47, the net realized at offering. This is a reasonable premium to pay for a development situation having the promise coming from such background. Long-term potential looks good from this point. Downside risk appears limited.

Larwin Realty and Mortgage Trust is typical of the intermediate term lending trusts coming into the hands of investors and so the lending practices evolving and the potential of this type of trust are worth examining in detail. These trusts are lending generally for terms ranging from five to 15 years, both on completed and development-state income properties.

Many of these trusts classify their investments as long-term, but their loans are quite different from the traditional long-term, fully amortizing mortgage. The controlling phrase is fully amortizing, for the loans made by these trusts generally will have a balloon (unpaid balance) at the end of the term. Trusts following this format in addition to Larwin include *Median Mortgage Investors*, offered just over a year ago, and *Mortgage Growth Investors*. Some long-term trusts also make these intermediate-type loans. (*Diversified Mortgage*, *Realty ReFund*, and *Security Mortgage* are also classified by us as intermediate term trusts but lend in essentially unrelated fields.)

The practice of balloon loans is brought into sharp focus by the Larwin offering Dec. 17, which indicates that $28.6 million of the trust's $66.2 million net proceeds

will be invested in 12 long-term first mortgages, only one of which is fully amortizing. The remaining loans are structured so that the borrower will have a balloon payment of varying size remaining at the end of the loan, which must then be refinanced.

Such balloon payments are by no means uncommon in the financing of income properties but the entire thrust of realty financing until the 1969-70 surge in interest rates was to eliminate balloons where possible. What is happening is that the borrowers are again resorting to the balloon-type loans to compensate for soaring interest rates and keep monthly carrying charges from making many projects unfeasible.

The new Larwin trust (which differs substantially from the already operating Larwin Mortgage Investors, a short-term construction lending trust) in essence slims the monthly payments for the borrower by basing repayment schedules on long-term amortization tables while the loan will come due before full repayment is made. For instance, one $3.97 million loan is for a 15-year term while monthly repayments will be made as if the loan were being repaid in 30 years. Another has a 10-year term but payments are based on a 25-year amortization plan, or table. Still another has a 6-year term but a 30-year amortization table.

Since very small amounts of principal are repaid in the early years of a very long term loan, the net effect of these plans is to leave sizable principal balances unpaid when they expire. For instance, a 25-year, 9% loan will have 82.7% of its principal unpaid at the end of 10 years and 66.2% unpaid at the end of 15 year. The following, derived from standard loan amortization tables, shows the balance remaining unpaid (the balloon) after five, 10 and 15 years when the repayment schedule is based upon longer-term amortization tables:

	9%			10%		
Unpaid after:	20 Yr.	25 Yr.	30 Yr.	20 Yr.	25 Yr.	30 Yr.
Five years	88.7%	93.3%	95.9%	89.8%	94.2%	96.6%
Ten years	71.0	82.7	89.4	73.0	84.6	90.9
Fifteen years	43.3	66.2	79.3	45.4	68.8	81.7

Very few prospectuses of these prototype intermediate term trusts have spelled out the use of long-term amortization tables in the manner of the new Larwin trust. One alternate way investors can use in spotting these balloon-type loans is to compare the interest rate on a loan and the annual constant payment. If the annual constant payment (i.e., the percentage of principal applied to both interest and principal during each year) is only slightly higher than the stated interest rate, then a very long amortization table is being used. Here are the relationships for several interest rate levels:

ANNUAL CONSTANT NEEDED TO AMORTIZE LOAN WITHIN ITS TERM

Term	8%	9%	10%
10 years	14.5596%	15.2016%	15.8580%
15 "	11.4684	12.1716	12.8952
20 "	10.0368	10.7964	11.5800
25 "	9.2616	10.0704	10.9044
30 "	8.8056	9.4080	10.5312

Note that as the term extends, the constant payment declines to very near the actual interest rate. After 30 years, the decrease is minimal. For instance, Median Mortgage's original offering prospectus reported typical loans in this vein: two 10-year loans with 11.5% interest and 11.89% constant payment; a six year loan with 11.75% interest and 12.89% constant; two 10-year loans with 11.75% interest and 12.12% constant.

Each loan obviously has a stretched-maturity to reduce monthly payments.

How risky are the balloons? No one really knows. The last spate of balloon-type realty financing occurred in the 1920s, and when the loans fell due in the 1930s, money and economic conditions had so changed that refinancing often became impossible. The widespread use of balloon-type loans on homes and the resulting widespread foreclosures led to creation of the Federal Housing Administration and its insistence upon fully amortizing loans for residences in 1934.

But income properties are markedly different. Rent levels, inflation levels and locations are now changing more rapidly than in years, especially in urban and fringe areas. Lenders many times seek the short-term maturities in order to get another look at their mortgage terms in 10 or 15 years. Borrowers, especially at today's high interest rates and equity kickers, also would like to review the bidding at that time. Hence the trend toward these intermediate term loans.

Larwin and Median are among the very first trusts to specialize in this area. Experience in Median has been good to date, but it is far too early to evaluate results fully. Our general feeling is that investors will recognize the risks inherent in this loan category by demanding yield of about 1% higher than for longer-term equity or mortgage trusts whose investments are covered by fully-amortizing loans. Median, for instance, is currently priced to yield 7.6%, about 1.25% higher than the estimated 6.35% yield from five large long-term trusts on the NYSE (Connecticut General, Equitable, Mass Mutual, MONY Mortgage and Northwest Mutual Life Mortgage.)

In the Larwin Realty situation, initial investments were to yield a weighted 10.2% and on this basis it appears the trust can earn about 8.0%-8.25% net after management fees and expenses on its post-offering book value of $18.32 per share. This would indicate dividends in the $1.50/share range for the year. If this dividend were to sell at the same 7.6% yield as Median, the shares would have capitalized value of $19.25-$19.75. At current bids of about 17 3/4, they would appear to have moderate appreciation potential until the dividend and earnings pattern comes into sharper focus.

THE MARKET TURNS MORE SELECTIVE FOR TRUST DEBT OFFERINGS

BT Mortgage Investors became the first REIT to sell a debt issue with a $20 million offering of 5 3/4% debentures and 600,000 warrants (30 warrants per $1,000 bond) Jan. 11. The offering was well received but underwriters, Eastman Dillon, Union Securities and Drexel Firestone, said buyers, especially in institutions, were selective. The offering is a relatively rare appearance of a subordinated debenture that is neither convertible or usable at par to exercise the attached warrants.

The sale at the relatively low coupon of 5 3/4% was aided by the fact the debentures have only a 10-year term, vs. the 20-year term common for most recent trust convertible offerings. Too, BT's sponsorship by the holding company for Bankers Trust Co. of New York, nation's 8th largest bank, helped cement the issue. The warrants are exercisable at $24 per share, vs. a 23 7/8 closing price the day prior to the offering, indicating the trust accepted very little exercise premium to obtain a lower coupon rate. Exercise price is 94.6% above the $12.33 book value for the 1,977,000 shares that would be outstanding assuming full conversion of outstanding 6 3/4% convertibles.

The *Alison Mortgage Investors* offering of $20 million debentures, expected momentarily at presstime, with 20 warrants per $1,000 bond, was being taken mostly by individuals. Institutions were on the sidelines. The coupon of 6 3/4%

on a 20-year debenture is on the high side but the offering raises trust capital (i.e., equity plus convertible debt) over $50 million, the level at which most trusts have qualified for issuing commercial paper. Pre-offering book value was $18.36 per share.

But other proposed trust offerings are having tougher going. *MONY Mortgage Investors*, sponsored by Mutual of New York Life Insurance Co., postponed a planned $50 million offering in the post-Nov. 18 market turmoil. *Atico Mortgage Investors'* proposed $25 million offering of subordinated debentures with related warrants (the so-called synthetic convertibles, see RTR Dec. 27) is delayed for the moment. *Heitman Mortgage Investors'* offering of $30 million convertibles is scheduled for the week of Jan. 17, with terms to be set.

Our description of the so-called synthetic convertibles in last RTR raised enough questions from subscribers that we wanted to expand. Some wondered whether our use of the term "synthetic convertibles" implied criticism. Not at all. However the investment banking fraternity uses the term and we believe it is most descriptive of the true nature of the offerings described.

The impact of such offerings on earnings per share also was questioned. We said last issue that such offerings increase primary earnings per share (because the adjustments required for primary earnings per share excluded convertibles). William S. Woods, Treasurer of Barnett Mortgage Trusts, one of two trusts which have already made such offerings, points out that the unamortized original issue discount arising from the offering is also carried as an asset on the balance sheet and the cost is amortized over the life of the debentures. And this amortization penalizes primary earnings per share. Here's the impact of Barnett earnings:

Original issue discount: $4.6 million on $20 million offering (or 23% discount)
Amortization of discount: $260,000 annually or $65 quarterly
Number of shares outstanding Sept. 30: 1,284,960
Cost per quarter: $0.04/per share ($0.05 including other issue expenses)

Since Barnett earned $0.65 per share primary in the September quarter, this then is <u>a 6.2% reduction in earnings per share</u> on the present rate. Similarly, Guardian Mortgage Investors finds the offering reduces earnings per share about $0.07 per share per quarter. The non-cash charge is similar to depreciation and can be retained or paid to shareholders as trustees decide. And while professional arbitrage between shares, debentures and the warrants has been a mild depressant to Guardian shares, arbitrage is difficult, if not impossible, with Barnett's unlisted shares.

While we do not wish to belabor you with legal or accounting technical discussions, we feel the above is needed to show some of the complexities of trust capitalizations and trust earnings reports. We repeat our advice of last issue: "<u>The only safe course for investors is to rely more heavily than ever upon quarterly dividend declarations and payments.</u>"

THE ANSWER CORNER: RECENT FILINGS, CAPITALIZATION RISK, GENERAL MORTGAGE INVESTORS

Q. Why did several large new REITs file registrations, despite the recent selloff?
A. Actually, the main filings were in before and not since the November 18 decline. A small number of filings have continued in line with past stated criteria: non-prime institutions that have specialized or regional positions. One of the major new filings, Institutional Investors, was already in existence as a private trust. Undoubtedly, new filings are more difficult than two months ago.

Q. Can REITs survive and prosper if the building industry slows down?

A. We must distinguish here between activity-related and condition-related trusts. Trusts that lend short term are activity related; their market is new construction. Long term and equity trusts are related to prevailing economic conditions; their ability to obtain rental levels and overrides depends on general prosperity. Thus if construction activity slows, the short-term trusts would be affected much more than the long-term trusts.

Q. Is there less risk in shares of REITs which have no convertible debt or warrants?
A. Warrants are not a risk factor. They are only exercised for shares if the share price rises above issue, a condition reflecting improvement. Convertibles, while considered equity capital, do entail a small measure of risk until converted. There is the remote possibility of unproductive loans not only wiping out share earnings and then cutting into the convertible debt coverage for any trust.

Q. What are the prospects for *General Mortgage Investments* and plans by new management?
A. Near term prospects are little changed as the trust is boxed in with 34% of its assets tied up in relatively low yielding FHA and VA mortgage loans and there are several bad loans. The former were made at 6-6 3/4% and would incur a loss of about $1 million if sold today. On two of the bad loans, Dallas, Texas and Kansas City, Missouri,the trust has had to take back short-term mortgage paper yielding only 8%. These total $3.1 million. Additionally, two loans necessitated foreclosure proceedings, these on properties in Seattle, Washington and Daytona Beach, Florida.

New management seems to have more extensive contacts and construction experience. The new adviser operates out of Goodrich Associates, a national real estate development controlled by Louis D. Cohen. He is a long time real estate developer and father of Arthur and Richard Cohen who head the Arlen complex *(Arlen Realty & Development, Arlen Property Investors)* and *GIT Mortgage & Realty Investors* respectively. Goodrich Associates seems to be a loosely connected group with contacts. They believe they can help obtain borrowings for the trust and serve to tighten lending practices, particularly in controlling on-site construction. The Goodrich organization will supplement the home office staff. The only leverage and/or growth possibilities available for now is the use of bank lines. The trust's balance sheet may have some room in this direction with equity exceeding debt by nearly 1.6 to 1 as of September 30. The new trustees' basic operating policy will be to clean up the bad loans and continue the short-term lending policy of making construction loans for FHA and VA projects. This category is where General has a reputation and staff. A clearer assessment of problem loans should have been available by now but unfortunately management has not been available to discuss this. For the time being, there is little hope for much improvement of the recent $0.96 a share annualized earning power.

IMPLICATIONS OF THE ECONOMY AND MONEY MARKETS FOR TRUSTS IN 1972

The recovery is heading for its second year amid no widespread enthusiasm. The trend is up, however, and the standard 1972 forecast calls for 5½-6% real growth in GNP with inflation hopefully moderating to 3-3½% from the more unhealthy 4.6% last year. Although spottiness remains the order of the day, a 15% profit improvement looks likely. Within this now familiar contradictory framework, renewing growth while curbing inflation, monetary ease and fiscal stimulus have been assigned the former task and Phase II controls the latter. Speculation on the eventual success of wage/price controls is most difficult and compounded by the political uncertainties engendered by a Presidential election. For the time, we assume controls will have some success and failing that, it would appear problematical that even stronger controls might be instituted for political preservation.

Near term, all signs point to downard interest rates. This is especially true in

the short term sector. Treasuries have pushed below 3 3/4%, Federal funds have been under 4% lately and the prime was just reduced to 5% with talk that it may go to 4 3/4%. The long term sector has not moved down much. Confidence in the abatement of inflation was marked since the President's initial freeze announcement in August which started long term rates down. Buyer resistance becomes noticable, however, in the lower 7% range. This despite the spread of 300 basis points between long and short rates, the greatest amount since the Thirties. Long-term rates are therefore under a predominance of downward pressure but unlikely to move very far very fast.

What are the factors working against lower rates? Recently short term rates were pushed down quickly. Absence of loan demand helped the prime cut. The concern is for 12-24 months out. As money demand picks up with the recovery of consumer and business confidence, coupled with the cumulative impact of the third large budget deficit, inflation pressures may be with us again. Controls, already under a shadow, may not be up to the task. The usual result would be higher interest rates. Thus the money markets and the investment community's expectations will bear watching during 1972, especially in the second half.

Trusts, while money market operations, are more like credit intermediaries, except where they already have their own borrowings tied up long term. The short-term trusts work primarily on spreads. After allowing for time lags after rate shifts, their placements should remain at the same spreads, assuming competitive conditions are equal. Trust shares on the other hand, being money market instruments, might require higher yields in a higher interest rate market, again other things being equal.

REIT MANAGEMENT COMPANIES CONFRONT THE LAZARD FRERES DECISION

A suit filed in Los Angeles has challenged the March 1971 sale of the management company for *Continental Illinois Realty* (formerly Mortgage Investment Group) to Conill Corp. The plaintiff, a shareholder named Marvin Ridley, alleges that the trust advisory company, formerly Group Counselors, Inc., and its owners profited from the sale of the company to Conill (see RTR, March 1, 1971 for transaction details) for a potential $14 million in stock, depending upon future earnings.

The suit cites the Lazard Freres decision (Rosenfeld V. Black) in which the U.S. Second Circuit Court of Appeals decided last June 22 that the manager of a mutual fund, a Lazard Freres subsidiary, could not profit on the sale of the company to another because common law held that a fiduciary could not sell his fiduciary office. The decision is at variance with an earlier decision (Insurance Securities) in which the Ninth Circuit Court of Appeals held that under the Investment Company Act "the evil toward which the Act is directed is the transfer of control without consent of the shareholders...not the money received by the assignors of service contracts." The Investment Company Act establishes procedures for transferring control of a management company for a mutual fund but the Lazard Freres decision ruled that common law forbade profits on the sale of a management company.

Following the decision Lazard Freres agreed to settle the case by returning $1 million of the $2.5 million advisory company sale price to the fund. That agreement was finally approved by a Federal district judge Jan. 6 in New York, but not before Lazard Freres had filed a petition last Dec. 10 asking review by the U.S. Supreme Court.

Besides the obvious implications for owners of mutual fund management companies, the Los Angeles suit now carries the potential for bringing sale of an REIT advisory company under these same restrictions. The Los Angeles suit is a derivative action, meaning that any recovery would go to the trust instead of to the individual plaintiff. But attorneys agree that it will be many months at best before any resolution is reached. In the interim we would not alter our view that Continental Illinois Realty, contained in our Model II Portfolio, is a sound holding.

Written as of noon Thursday, Jan. 13.